PBGC
Protecting America's Pensions
Pension Benefit Guaranty Corporation
1200 K Street, N.W., Washington, D.C. 20005-4026

Office of the Executive Director

June 30, 2005

The Honorable George Miller
U.S. House of Representatives
Washington, D.C. 20515

Dear Congressman Miller:

This letter is in response to your requests for information regarding the Administration's comprehensive pension reform proposal and H.R. 2830. PBGC has done a substantial amount of modeling and analytical work related to the challenges facing the defined benefit (DB) system and the pension insurance program, and this work continues. Currently, we are working to modify the PBGC's Pension Insurance Modeling System (PIMS) to analyze the impact of H.R. 2830.

Some of the questions you pose are specifically addressed in our White Paper titled "Analysis of the Administration's Pension Funding Reform Proposal: Impact on Contributions, Funded Ratios, and Claims against the Pension Insurance Program," which we released on April 6, 2005. The White Paper can be found at http://www.pbgc.gov/publications/white_papers/wp_040605.pdf.

You posed several questions related to modeling of the Administration's proposals. In this regard, it is important to understand the limits of our modeling capabilities, especially as they relate to some of the questions you pose. I would note that PIMS is not designed or intended to provide a single answer with regard to outcomes, but rather to provide ranges of possible outcomes. The stochastic modeling capabilities of PIMS are quite useful for ascertaining the direction and magnitude of policy changes. For example, as discussed more fully in the White Paper, our modeling demonstrates that if the Administration proposal is enacted, funded ratios will improve and expected claims would be lower than under current law.

The long-run cost of pension benefit obligations does not vary with the method chosen to fund those obligations. The Administration's proposal is designed to encourage sponsors to fund such obligations more quickly after they are incurred than is the case under current law in order to protect plan participants from the risk of benefit losses should a plan terminate in an untimely manner. Therefore, the proposal requires larger sponsor contributions in the short run in order to reduce benefit losses and claims against the pension insurance fund. For example, for the first ten years the proposal is in effect, required contributions will increase approximately 29% under the stable economy scenario described in the Funding Reform White Paper. If the projection period were expanded to 20 or 30 years, the average increase, if any, would be significantly lower, because, as explained above, the ultimate cost of providing benefits does not change.

Other provisions of the Administration proposal that will improve the financial position of the pension insurance program are (1) providing PBGC with the authority to perfect liens in bankruptcy and (2) eliminating shutdown benefits. For example, if PBGC had the ability to perfect liens in bankruptcy, liens totaling $770 million could have (and most likely would have) been perfected against United Airlines. The actual recovery would have depended on the unencumbered assets subject to the lien. As for shutdown benefits, the PBGC has assumed over a billion dollars of unfunded shutdown liabilities over the past ten years. We estimate that the value of unfunded shutdown benefits in DB plans today exceeds $10 billion. Unless the law is changed, the PBGC will most likely assume a sizable portion of that amount.

Under the Administration's proposal, the discount rate used to determine plan liabilities will also be used to determine minimum lump sum payments. By using the same rates for both purposes, an employee's decision to receive a lump sum will not adversely affect the plan. That is not the case under current law.

Currently, minimum lump sums are based on 30-Year Treasury Rates which tend to be much lower than mandated discount rates used to determine current liability. For example, a calendar year plan may be using a discount rate of 4.86% (the October 2004 30-year rate) for a distribution that occurs in 2005. With the yield curve approach, instead of using one single rate to discount future benefit payments, a series of rates that vary over the expected payment period is used. However, for comparative purposes, a single rate can be derived that would produce the same lump sum as the yield curve. Using the 12/30/04 yield curve from Treasury's White Paper dated February 7, 2005, we derived the single interest rate that would provide the same lump sums to three hypothetical participants ages 40, 55, and 65. The equivalent level rates were 6.4%, 5.9%, and 5.3% respectively. This calculation would vary over time, depending on the steepness of the yield curve. Furthermore, the calculation does not reflect the impact of the transition rule in the Administration's proposal.

You asked us to assess the impact on plan freezes or terminations that would result under the Administration's proposal. It is difficult to accurately predict behavioral changes. The variables contributing to a company's decision to freeze or terminate a pension plan are numerous, and largely unique to its own financial and human resource needs. As you may know, since ERISA's enactment, there have been 165,000 standard terminations, 3,500 distress or involuntary terminations[1] and many sponsors have implemented some sort of plan freeze. According to recent Form 5500 filings, 2,700 plans have been amended to cease all future benefit accruals (whether because of future service or future compensation). These frozen plans represent approximately 9% of the remaining insured single-employer DB plans. All this is occurring under current law.

Some have argued that the Administration's proposals will accelerate these trends. We have seen no evidence to support this assertion. On the contrary, we believe that the Administration's proposal would strengthen the system by placing both individual pension plans and the pension insurance program on sound financial footings. Under the current system, there are significant disincentives for new employers to create defined benefit plans, such as the substantial deficit of the sponsor-financed insurance fund. Prospective defined benefit sponsors are also aware that the current complex system of funding rules allows some sponsors to transfer the risks of their funding and investment decisions to that same insurance system. We believe that these considerations – risk transfers and administrative complexities – also make defined benefit plans less attractive to prospective plan sponsors.

The Administration's proposal will correct these flaws. Simplifying the rules, tightening funding requirements, providing additional flexibility to make tax deductible contributions, and returning the pension insurance program to financial health will make defined benefit plans more attractive to employers who are now outside the system. Moreover, the assertion that companies will exit the system solely because of any changes being proposed should be viewed with some skepticism. Notwithstanding the voluntary nature of the system, there are other limits on an employer's ability to leave the pension system, including existing collective bargaining agreements. In addition, for a company to be able to effect a standard termination of a plan that it sponsors, it must fully fund the promised benefits by paying them in a lump sum or buying an annuity

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[1] In a distress or involuntary termination, participants lose promised benefits. PBGC published a study analyzing benefits lost upon plan termination. This study is available at http://www.pbgc.gov/publications/databook/databook99.pdf .

from an insurance company. Given the extent to which most plans are underfunded, many companies may not have sufficient cash resources available to effect a standard termination in the near term. Moreover, if they are able to get their plan to fully funded status, the financial burden on the employer to maintain the plan would be substantially less.

Again, we continue to model various aspects of the Administration's comprehensive pension reform proposal as well as H.R. 2830 and other policy initiatives.

Sincerely,

Bradley D. Belt

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